Before the
Federal Communications Commission
Washington, D.C. 20554

In the matters of	)	
	)	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers	)))))	**CC Docket No. 00-256**
Federal-State Joint Board on Universal Service	))	**CC Docket No. 96-45**
	)	
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	)))	**CC Docket No. 98-77**

Reply Comments of ALLTEL Communications, Inc., CenturyTel, Inc., Madison River Communications, LLC, and TDS Telecommunications Corporation

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Table of Contents

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ALLTEL Communications, Inc., CenturyTel, Inc., Madison River Communications, LLC, and TDS Telecommunications Corporation (the "Joint Commenters") hereby submit the following reply comments in response to the Commission's Notice of Proposed Rulemaking the ("Notice") in the above-captioned proceedings.[1]

I. SUMMARY

In this proceeding, the Joint Commenters urge the Commission to immediately eliminate the all-or-nothing rule. As evidenced by the Commission's repeated waiver of the all-or-nothing rule, the fact that supporters of the all-or-nothing rule failed to cite any abuses justifying retention of the rule, and that there are other safeguards that prevent improper cost-shifting, the Commission's original concerns that carriers operating under dual forms of

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[1] *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers,* CC Docket No. 00-256 ("*MAG Further Notice*").

regulation would improperly shift costs between their price cap and rate-of-return affiliates was overstated.

Instead of adopting price cap regulation, which has failed to serve rural America, the Joint Commenters strongly encourage the Commission to create a five-year transitional, incentive-based alternative rate regulation plan that rate-of-return carriers have the option to elect on a study-area-by-study-area basis. In light of the diversity among rate-of-return carriers, the Commission should reject AT&T's and other commenters' suggestion that the Commission adopt price cap regulation for rate-of-return carriers, which would benefit the IXCs. Instead the Commission should focus on the public interest, and adopt an incentive plan that motivates carriers to continue investing in rural America.

Given the growing level of competitive entry in rate-of-return markets, the Commission should also grant rate-of-return carriers pricing flexibility immediately. The criteria for determining whether a carrier qualifies should be reasonable and should give ILECs incentives to further open their local markets. Unlike price cap regulation, an alternative incentive-based regulation plan will promote efficient competition and the deployment of advanced services in rural America. The Commission should act promptly to eliminate the all-or-nothing rule by July 1, 2002, and allow rate-of-return carriers to elect alternative regulation no later than January 1, 2003.

II. THE COMMISSION CAN AND SHOULD IMMEDIATELY ELIMINATE THE ALL-OR-NOTHING RULE.

The Commission's original concern that carriers operating under two different forms of rate regulation would improperly shift costs from their price cap affiliates to their rate-of-return affiliates was overstated. Contrary to the vague allegations of AT&T and CUSC, competitive entry neither increases the incentive to shift costs improperly nor makes such activity harder to detect. Further, the Commission has repeatedly waived the all-or-nothing and one-way-door rules since they were first adopted and, despite a few years of experience now with carriers that have operated partly under price cap regulation and partly under rate-of-return regulation, there have been no proceedings alleging gaming or improper cost-shifting before the Commission. This silence on the part of those parties that vigilantly monitor the ILECs' cost allocation and jurisdictional separations processes demonstrates that these rules have long-outlived whatever usefulness they originally had. The supporters of the all-or-nothing rule plainly ignore the fact that the Commission already has other rules in place to prevent improper cost-shifting. For example, many carriers are required to file cost allocation manuals setting forth the procedures that they use to allocate costs between regulated and nonregulated activities.[2] Many also are required to perform independent audits of reported cost allocation data.[3] State commissions also regulate a carrier's costs, and public companies are independently audited every year. Finally, IXCs, CLECs, and others are able to review ILEC tariffs to detect any improper cost-shifting.

A. The Commenters Fail to Cite Any Abuses Justifying Retention of the Rule.

Commenters that favor retaining the all-or-nothing rule argue that, without the rule, carriers would have the incentive to game the system by increasing their costs prior to opting into incentive regulation and decreasing their costs to maximize profits under incentive regulation.[4] They also claim that carriers might seek to shift costs improperly from their

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2 47 C.F.R. §64.903.

3 *Id.*

4 CUSC Comments at 2, 5; Sprint at 6-7; Worldcom at 4.

affiliates that operate under incentive regulation to their rate-of-return affiliates.[5] These commenters, however, have not placed on the record any examples of such abuses to support their speculative claims. Nor have they cited to or filed a single federal or state complaint alleging such abuses. This lack of evidence is unsurprising because the Joint Commenters, too, are unaware of any federal or state commission finding that a rate-of-return carrier has ever engaged in this type of cost-shifting. The record *does* demonstrate that the all-or-nothing rule simply is not necessary to achieve the purpose for which it was adopted.

Although the Commission has gained experience with carriers operating under both price cap regulation and rate-of-return regulation primarily in the past three years, many states have for some time permitted carriers to elect alternative regulation without requiring them to do so on an all-or-nothing basis, and without imposing any particular safeguards.[6] These states typically have not imposed additional conditions on carriers to guard against cost-shifting between affiliates operating under different forms of regulation, yet there is no evidence of actual cost-shifting.

The Commission's experience with its universal service mechanisms also demonstrates that the Commission does not need to adopt any safeguards against cost-shifting beyond those already contained in its rules. The Commission today regulates non-rural carriers (which receive universal service support based on the results of a cost model)[7] that are affiliated

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5 *Id*.

6 Among the states in which the Joint Commenters operate, at least half of the state commissions permit carriers to opt into different forms of regulation. These states include Arkansas, Colorado, Indiana, Minnesota, Mississippi, Ohio, Tennessee, Texas, Wisconsin, and Wyoming. In some instances the state requires that all of the exchanges within a particular operating company, but not the entire holding company, operate under the same form of regulation.

7 *Federal-State Joint Board on Universal Service*, Ninth Report and Order and Eighteenth Order on Reconsideration, 14 FCC Rcd 20432 (1999).

with rural carriers (which receive universal service support based on their own costs).[8] Throughout the extensive consideration of these mechanisms and extensive comment from a vast array of parties, the Joint Commenters are unaware of any allegation from any party, including the Commission, that any additional safeguards were necessary to prevent cost-shifting to inflate the apparent costs of the rural affiliates and boost the federal universal service support to which they are entitled. Just as the Commission did not consider cost-shifting a significant issue in the universal service context, so is it justified in concluding in this proceeding that its original cost-shifting concerns in the pricing context were misplaced.

B. **Other Safeguards Already Exist That Prevent Improper Cost-Shifting.**

As Verizon correctly points out,[9] numerous safeguards are already in place today to guard against cost-shifting. State and federal tariff processes and the Commission's cost accounting, separations, and affiliate transaction rules were designed to prevent cost-shifting to a carrier's rate-of-return affiliates and to make any cost-shifting easily detectable.[10] In addition, Section 204 of the Communications Act of 1934, as amended,[11] gives the Commission broad powers, which it frequently exercises, to investigate the rates that carriers file in their tariffs and to examine the cost support provided therein.

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8 *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Fourteenth Report and Order and Twenty-Second Order on Reconsideration, *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, Report and Order, 16 FCC Rcd 11244 (2001), ¶¶28-29 *("RTF Order*").

9 Verizon Comments at 4-5.

10 *See e.g.*, *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order In CC Docket No. 96-149 and Third Report And Order In CC Docket No. 96-61, 12 FCC Rcd 15756 (1997) ("*LEC Classification Order*") (deciding that separate affiliates with separate books of account sufficiently protects against improper allocation of costs between an incumbent LECs' local services and interexchange services); *Amendment of the Commission's Rules to Establish Competitive*

Competitors, in particular, as well as access customers and end-user customers will review the relevant tariffs to detect any improper cost-shifting. AT&T itself actively reviews tariffs filed by rate-of-return ILECs on an ongoing basis.[12] Furthermore, removing implicit subsidies from interstate access rates and making universal service support portable were significant steps toward increasing competition[13] which, in turn, creates additional competitors to monitor ILEC tariffs for improper cost-shifting.

For nearly 10 years now, the Commission has had accounting safeguards that govern the allocation of carrier costs between regulated and unregulated activities.[14] These rules, which were adopted "to protect regulated ratepayers from absorbing the costs of nonregulated activities,"[15] flatly prohibit an ILEC from shifting costs incurred by one affiliate to another. Similarly, one of the main purposes of the Commission's affiliate transaction rules in Section 32.27 is to protect ratepayers by preventing ". . . the ability of carriers to shift the investment risk of nonregulated activities to the regulated entity and its ratepayers."[16] Finally, the Commission

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Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services, Report and Order, 12 FCC Rcd 15668 (1997) ("*LEC-CMRS Order*") (local service and CMRS separation).

11 47 U.S.C. §204.

12 Petition of GCI (filed Dec. 21, 2001) in CC Docket No. 02-36, CCB/CC Docket No. 01-28; Petition of AT&T Corp. (filed Dec. 26, 2001) in CC Docket No. 02-36, CCB/CC Docket No. 01-28.

13 *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, Federal-State Joint Board on Universal Service, Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation, Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, FCC 01-304, (Nov. 8, 2001) ("*MAG Order*").

14 47 C.F.R. §§64.901- 64.904.

15 *Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase I*, Report and Order, 15 FCC Rcd 8690, ¶11 (2000).

16 *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transactions Between Telephone Companies and Their Affiliates*, Joint Cost Order on Reconsideration, CC Docket No. 86-111, 2 FCC Rcd 6283, 6295, ¶109 (1987).

has adopted separations rules that require an ILEC to divide its regulated costs into two jurisdictional categories, thereby preventing carriers from recovering the same costs in both the interstate and intrastate jurisdictions.[17] These rules collectively already serve the purpose of preventing improper cost-shifting, making it unnecessary for the Commission to retain the all-or-nothing rule.

In addition, there have been numerous changes in the Commission's rules and the marketplace that make it impossible for carriers to shift costs illegally. Significantly, in an effort to establish a "procompetitive, deregulatory national policy framework" and to promote more efficient competition, the Commission recently has adopted rules that more closely align rates with costs. In the *MAG Order*, for example, the Commission aligned the interstate access structure more closely with the manner in which costs are incurred and replaced the implicit support in the access charges with explicit, portable support.[18] Specifically, the Commission shifted the non-traffic sensitive costs of local switch line ports to the common line category and reallocated the remaining costs in the transport interconnection charge (TIC) to other access rate elements.[19] In addition, the Commission increased the SLC, concluding that the "measure [would] benefit consumers by fostering efficient competition, reducing overall rates, and increasing the transparency of the interstate access rate structure."[20] To recover any shortfall between the allowed common line and SLC revenues, the Commission created the Interstate Common Line Support mechanism, which is available to all eligible telecommunications

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17 *See* 47 C.F.R. §36.

18 *MAG Order* at ¶3.

19 *Id.* at ¶¶91, 99.

20 *Id.* at ¶43.

carriers,[21] and permitted carriers to disaggregate and target portable high-cost support below the study area level to further encourage efficient competitive entry.[22] Similarly, in the *RTF Order* the Commission disaggregated and targeted high-cost support because it would "facilitate competitive entry into high-cost areas, bringing the benefits of competition to consumers in rural areas."[23] By aligning rates with costs and ensuring that support can be disaggregated, the Commission has paved the way for more efficient competitive entry.

Due in part to the aforementioned rule changes and the Commission's overall local market-opening policies, competition has increased significantly since passage of the Telecommunications Act of 1996. Rate-of-return LECs face increasing competition from resale and facilities-based LECs as well as CMRS carriers, cable operators, and satellite broadband providers. In many ways, however, the Commission's rules hinder incumbent LECs from being able to compete with these new technologies.[24] ILECs not only are limited by their earnings, but they often are unable to competitively price their services, both of which can be economically detrimental in today's converging telecommunications environment. As a result of technological advancements and regulators' inability to anticipate how competitors may exploit inconsistencies in regulation, competitors are able to offer unregulated services that are functionally equivalent to heavily regulated services. Such imbalances in regulatory burdens create incentives to exploit artificial competitive advantages and slant competition in favor of one class of providers over

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21 *Id.* at ¶28.

22 *Id.* at ¶143.

23 *RTF Order* at ¶27.

24 Joint Comments of Alltel Communications, Inc., CenturyTel, Inc., Madison River Communications, LLC, and TDS Telecommunications Corp. at 3-6 (filed Feb. 14, 2002) ("Joint Comments"). Joint Comments at 19-22.

another.[25] ISPs, for instance, are able to offer Internet telephony free of interconnection fees and are not required to contribute to universal service. In addition, until last year, the Commission's rules encouraged CLECs to route significant amounts of ISP-bound traffic to the ILEC network in an effort to receive substantial reciprocal compensation payments from the ILEC. While ILECs are subject to extensive state regulation, CMRS carriers and cable operators typically are not, which also increases their competitive advantages over ILECs. In light of the flexible pricing packages that competitors, such as wireless carriers, are able to offer, rate-of-return carriers have experienced declining growth in line counts and interstate minutes. In short, contrary to AT&T's suggestion, constraining regulation and actual competition (or even the threat of competitive entry) remove any ability for an ILEC to sustain above-market pricing.

C. AT&T Offers No Empirical Evidence Against All-or-Nothing Rule Waivers.

There also is no basis whatsoever for AT&T's unsupported speculation that the Commission's waivers of the all-or-nothing rule for acquisitions have "undoubtedly cost consumers millions of dollars in lost access charge reductions."[29] To the contrary, until 2000 when the *CALLS Order* was adopted, the Commission's price cap rules required price cap carriers, whenever they sold off high-cost exchanges from a study area, also to reduce their

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[25] Rob Friedan, "Regulatory Opportunism in Telecommunications: The Unlevel Competitive Playing Field," CommLaw Conspectus, Journal of Communications Law and Policy, 81.

[26] Verizon Comments at 4-5.

[27] *See, e.g.*, *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order In CC Docket No. 96-149 and Third Report And Order In CC Docket No. 96-61, 12 FCC Rcd 15756 (1997) ("*LEC Classification Order*") (deciding that separate affiliates with separate books of account sufficiently protects against improper allocation of costs between an incumbent LECs' local services and interexchange services); *Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services*, Report and Order, 12 FCC Rcd 15668 (1997) ("*LEC-CMRS Order*") (local service and CMRS separation).

[28] 47 U.S.C. §204.

prices exogenously for the remainder of the study area to offset the sale of the higher-cost lines.[30] Additionally, it is far from clear what impact, if any, reductions in rate-of-return carrier access charges have on consumer-paid long-distance rates. As required by the *MAG Order*, traffic-sensitive charges assessed by rate-of-return carriers have fallen by approximately one-third, while the TIC has been eliminated entirely.[31] As indicated in the Joint Commenters' initial comments in this proceeding, these changes have lowered carrier-paid interstate access charges assessed by rate-of-return carriers by $900 million.[32] Thus, contrary to AT&T's claims, access charges have been reduced substantially in rate-of-return study areas; however, whether the IXCs have passed those savings on to consumers is quite a different question, which should be addressed to the IXCs – not the LECs. It is not waivers of the all-or-nothing rule, but AT&T's failure to offer all Americans its lowest-cost rate plans, that has cost consumers "untold dollars" in inflated long-distance bills.

D. The "One-Way Door" Rule Should Be Retained, Subject to Waiver.

The Joint Commenters do not oppose retaining the one-way door rule so long as carriers may petition for waiver of the rule in hardship cases. Pursuant to Section 61.41(d) of the Commission's rules, once a LEC becomes subject to price cap regulation, it is not permitted to withdraw from such regulation.[33] Thus, if the one-way door rule were retained, a waiver would be required before a carrier electing incentive regulation could convert its exchanges to rate-of-

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29 AT&T Comments at 19.

30 *LEC Price Cap Performance Review,* First Report and Order, 10 FCC Rcd 8961, 9104-06 (1995). In light of the established target rates set forth in the *CALLS Order*, such exogenous price reductions on a going-forward basis became unnecessary.

31 *MAG Order* at ¶¶98-104.

32 *MAG Order,* at ¶¶98-99.

33 47 C.F.R. §61.41(d).

return regulation, as is the case today. Preservation of this rule, therefore, would give the Commission sufficient opportunity at the time of the request to fully consider whether such a change in regulatory status would result in the kind of "gaming" of the system that concerned the Commission when it adopted the all-or-nothing rule. The Commission should grant waivers of the one-way door rule in hardship cases.[34]

III. THE COMMISSION SHOULD MAKE ANY NEW RATE REGULATION PLAN OPTIONAL BY STUDY AREA.

As the Joint Commenters noted in their initial comments, the diversity among rate-of-return companies dictates that any incentive regulation plan adopted by the Commission should be optional by study area, and there should be no new conditions precedent to opting into such an incentive regulation plan.[35] Just as the all-or-nothing rule is inappropriate under price cap regulation, it also would be unsuitable for the Commission to carry any vestiges of the rule forward under any alternative form of regulation, because the rule is not necessary, as described above. Rather than impose an alternative form of regulation on entire holding companies, the Commission should allow carriers the freedom to decide for themselves, on a study area basis, whether incentive regulation is appropriate for their properties. Like the price cap all-or-nothing rule, any regulation that requires carriers to elect incentive regulation for all its study areas will unnecessarily constrain carriers and deny customers the benefits associated with incentive regulation. It is precisely the all-or-nothing rule, combined with ill-suited price cap regulation, that has encouraged the BOCs to abandon their rural exchanges over the past 10 years.

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[34] The Joint Commenters continue to urge the Commission, in adopting a new form of incentive regulation for rate-of-return carriers, to make such regulation transitional over a five-year period and to adopt only a limited one-way door rule that would sunset at the conclusion of the five-year period. Joint Comments at 3-8.

[35] Joint Comments at 3-6. "TCA" seems to support the position that incentive regulation should be optional as well, stating that, "a rational, reasonable path to take in this proceeding demands complete optionality,"

Mandatory alternative regulation would ignore the diversity that exists among rate-of-return carriers and disregard the mixture of study areas within holding companies.

As the Commission concluded when it adopted price cap regulation for the largest carriers, the diversity among smaller rate-of-return carriers makes it uncertain whether they would successfully operate under price cap regulation.[36] Today, rate-of-return carriers are equally, if not more, diverse than they were in the 1990s. Although the Joint Commenters all specialize in providing voice and data services to customers in predominantly rural and small urban markets, the loop counts and unseparated common line revenue requirements for the 193 ILECs that they operate vary dramatically.[37] As Attachment 1 demonstrates, costs do not necessarily correlate with the size of the carrier. For example, these operating companies range in size from approximately 100 lines to 325,000 lines,[38] but the unseparated common line revenue requirements for the same ILECs range from $200 to $1800 per line per year, with wide variations in revenue requirement among companies with comparable loop counts. Thus, few, if any, generalizations can be drawn about these carriers based on their costs. Consequently, it would be difficult, if not impossible, for the Commission to analyze and determine whether incentive regulation is appropriate for any given carrier or any of its individual study areas. For these reasons, the Joint Commenters urge the Commission to permit rate-of-return carriers the option of electing incentive regulation on a study-area by study-area basis.

IV. PRICE CAP REGULATION HAS NOT SERVED RURAL AMERICA WELL, AND IS NOT THE RIGHT PLAN FOR RATE-OF-RETURN CARRIERS.

TCA Comments at 2-3, although at other points, TCA seems to advocate a competitive trigger that would permit an ILEC to elect incentive regulation. Comments of TCA at 3.

36 *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6818, ¶¶262-63 (1990) ("*Price Cap Order*").

37 Attachment 1.

38 Joint Comments at 5.

As the Joint Commenters stated in their initial comments,[39] price cap regulation has largely failed rural America. Contrary to Sprint's disingenuous comment that service quality did not decline under price cap regulation,[40] the evidence is overwhelmingly clear that mandatory price cap carriers have abandoned many of their rural exchanges.[41] It stands to reason that price cap regulation simply discourages large carriers with mixed study areas from investing in the higher-than-average-cost areas.

A. **Price Cap Regulation Has Produced Poor Results in Rural America.**

Sprint's argument that service quality has not declined ignores all of this ample real-world evidence, as well as numerous state proceedings initiated to force BOCs to improve the quality of service provided to their customers in high-cost areas. For example, following a three-year period in which US WEST had failed to meet the quality of service standards, the Arizona Corporation Commission held a forum in 1999 designed to assure that service quality improved for US WEST customers.[42] In April 2001, the Oregon Public Utility Commission announced that it had earmarked $750,000 in service quality fines assessed against Qwest to replace all remaining analog carrier systems. The Oregon PUC stated that the older technology prevented rural customers from receiving faster Internet connections and custom calling

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39 Joint Comments at 8-12.

40 Sprint Comments at 2.

41 Joint Comments at 8-12; "Reshaping Rural Telephone Markets," Legg Mason Wood Walker, Inc. (Fall 2001) at 156 ("[V]irtually every acquirer of RBOC lines has reported difficulties with cabling and serving electronics. VALOR reported that it was required to completely reinstall its outside plant in one region, where there was extensive use of lead cable."); Overall RBOC Service Quality State Complaint Rate, ARMIS 43-05, Table V (demonstrating the number of residential customer complaints against BOCs steadily increasing since 1997) .

42 US WEST Service Quality Forum, Arizona Corporation Commission News Release (dated Aug. 25, 1999).

features.[43] In July 2000, the Public Utilities Commission of Ohio ordered SBC/Ameritech Ohio to pay more than $5.1 million in credits and waivers to more than 122,000 of its customers for violation of the minimum telephone service standards, to spend an additional $2.65 million in a manner that benefits its customers, and to restore its service to appropriate levels or face an additional $122 million penalty.[44] In September 2000, the Public Service Commission of Wisconsin opened a formal investigation into Ameritech's quality of service, requesting that Ameritech submit extensive data on its performance in the areas of infrastructure investment, maintenance, and outage rates.[45]

B. There is no Credible Evidence that the Current Price Cap System is Appropriate for Rate-of-Return Carriers.

AT&T, Sprint and Worldcom[46] argue that smaller rate-of-return carriers should be able to achieve productivity levels similar to or greater than those of current price cap carriers. The very notion that smaller rate-of-return carriers could achieve the productivity levels close to those of the largest four carriers is unsupported by any evidence and wholly self-serving, particularly in light of the shifts in customer demand for communications services in recent years.

AT&T argues in support of requiring incentive regulation for rate-of-return carriers by comparing the MAG plan with what it claims are actual revenues for rate-of-return

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43 "Commission Directs Qwest Service Quality Fines Toward Equipment Upgrades," Oregon Public Utility Commission Press Release (Apr. 6, 2001).

44 *In the Matter of the Commission-Ordered Investigation of Ameritech Ohio Relative to Its Compliance with Certain Provisions of the Minimum Telephone Service Standards Set Forth in Chapter 4901:1-5, Ohio Administrative Code*, Opinion and Order, Case No. 99-938-TP-COI.

45 *Investigation into the Quality of Telecommunications Services Provided by Wisconsin Bell, Inc., d/b/a Ameritech Wisconsin*, Order and Notice of Investigation, Assessment of Costs and Public Hearings, Sept. 14, 2000.

46 AT&T Comments at 8-12; Sprint Comments at 3-5; Worldcom at 2-3.

carriers from 1995-1999,[47] and claiming that rate-of-return carriers would have realized $424 million more in revenues than they did under rate-of-return regulation.[48] First, such a conclusion is not surprising given that carriers experienced unprecedented access line and minute growth during the relevant time period analyzed, which AT&T conveniently fails to acknowledge. However, AT&T's conclusion has little to do with productivity gains. Rather, it more appropriately accounts for the fact that growth in access lines and minutes will inevitably lead to increases in revenues if rates remain constant. Second, AT&T's analysis bears little value for the purpose of predicting future revenues under price cap regulation because growth for access lines and minutes today is flat. Third, if the results were as compelling under price cap regulation as AT&T posits, more rate-of-return carriers would have elected price cap regulation during the period 1995-1999 to reap the rewards, but few did. Smaller rate-of-return carriers, such as Citizens, Valor and Iowa Telecom, that elected price cap regulation since 1999 have not experienced pure success. Iowa Telecom, for example, filed a petition seeking a target rate increase because the CALLS target rates were too restrictive in light of the investments it has had to make in new plant, equipment, and services.

There are several other flaws with AT&T's analysis. First, AT&T erroneously assumes that common line revenue and access rates grew at the same rate.[49] However, as the Joint Commenters stated in their initial comments, access line growth, in fact, declined during the period 1990-2000.[50] In addition, AT&T's analysis of the traffic sensitive pool for 1999 and 2000 is based on access minute projections that were filed in NECA's tariff filing for 1999 and

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47 AT&T Comments at 8-12.

48 AT&T Comments at 8.

49 AT&T Comments at 10.

50 Joint Comments at 22.

2000, but it does not include the corresponding revenue requirements for the same period, making its entire calculation unreliable.

The decline in demand also was largely unanticipated. Carriers generally were unable to predict the dramatic shifts in 800 and other long distance traffic to wireless services and the Internet, both of which significantly contributed to declining growth in access minutes in 1999 and 2000. These types of changes in the competitive environment, which have occurred since the Commission mandated price cap regulation for the largest LECs in 1990, further underscore why price cap regulation is inappropriate for many rate-of-return carriers in today's marketplace. Customers are making fewer calls using the public switched network and seeking alternative means for communicating, such as e-mail or wireless service. Indeed, Chairman Michael Powell summed it up best:

> Communications to me is a way of calling my mother. . . . I do things that I was never able to do just a few years ago. I might e-mail her. I think that's a threat, that's a competitive alternative to picking up the local telephone. I might instant message my sister. That is a lost opportunity cost to the local telephone system. . . . [W]e underestimate the value of wireless, as a substitute for local services. I make many calls on my wireless phone, sitting in the driveway of my house, the front yard while I'm gardening, and I haven't picked up the phone in a hotel in five years, because I use my wireless phone. That's all coming out of what would have been a traditional call by a local company or an incumbent.[51]

AT&T grossly overstates growth in access minutes because it did not properly adjust for acquisitions made by rate-of-return carriers during this period. Premised on projections and exaggerated growth calculations, rather than actual figures, AT&T's conclusion that rate-of-return carriers would have realized significantly more revenues in 1999 under incentive regulation than they did under rate-of-return regulation is flawed. Furthermore, as applied in today's regulatory environment, revenues under price cap regulation for rate-of-return

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[51] Forrester Research Telecom Forum, Q&A with Chairman Powell, May 21, 2001.

carriers would be even smaller. For example, access minute and line growth rates continue to decline and have turned negative for some carriers.[52] The Commission, therefore, should pay little or no credence to AT&T's misleading conclusions, which are based on erroneous data and flawed methods. Even if such egregious mistakes could be corrected, the Commission still should consider whether AT&T's analysis has any relevance given the recent shifts in demand.

Simplistically arguing in support of imposing mandatory price cap regulation on rate-of-return carriers, AT&T notes that a "representative sample" of price cap carriers reduced switched access rates by more than 60% since 1996, a rate of decrease that it alleges has not been matched by rate-of-return carriers.[53] In drawing the conclusion from this comparison that the Commission should immediately impose price cap regulation (including a 10 percent X-factor) on all rate-of-return carriers, AT&T must resort to a wholesale re-write of history that should be given no weight. Among other glaring defects, AT&T's analysis does not address the fact that such reductions were the direct result of changes to the price cap rate structure that shifted significant interstate access costs to end-users through increases to the SLC caps and included substantial one-time rate reductions such as that required by the *CALLS Order*.[54] AT&T also disingenuously omits any analysis of the impact of analogous interstate access rate restructuring that the Commission mandated for rate-of-return carriers in the *MAG Order*, discussed above, by using a time frame in its analysis that includes changes to access rates as the result of the *CALLS Order* but excludes changes to access rates as the result of the *MAG Order*. AT&T also fails to note that, in 1996, the starting point for its analysis, access rates for many price cap carriers were

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[52] Joint Comments at 20, 22.

[53] AT&T Comments at 18.

[54] *In the Matter of Access Charge Reform, Price Performance Review for Local Exchange Carriers, Low Volume long-Distance Users, Federal-State Joint Board on Universal Service,* CC Docket Nos. 96-262, 94-1, 99-249, and 96-45*,* Report and Order, 15 FCC Rcd 12962 (May 31, 2000) *("CALLS Order").*

significantly higher than those of many rate-of-return carriers. According to AT&T, in 1996 ALLTEL had a switched access rate of $0.03, CenturyTel's was $0.044, while Puerto Rico charged at a rate of $0.048.[55] For that same year, Citizens had rates of $0.057 and $0.089, while Sprint's rates ranged from $0.036 to $0.067. The GTE companies' switched access rates ranged from $0.03 to $0.077.[56] At the same time, most price cap carriers were earning interstate returns exceeding 20%, while rate-of-return carriers were authorized to earn only 11.25%.

As even GCI acknowledges,[57] a one-size-fits-all approach is inappropriate because different productivity levels will be achieved by different carriers, in different areas, and for different types of investment. There is ample evidence that small companies cannot make the same workforce reductions, purchase in the same quantities, or otherwise achieve the same efficiencies as the BOCs. As GVNW noted in its initial comments,[58] because rural carriers have varying cost and operating characteristics,[59] it would be difficult for the Commission to account for these differences and simultaneously achieve the same goals as the productivity factor that the BOCs currently use. By way of example, Iowa Telecommunications Services, Inc. recently sought forbearance from a rule in the *CALLS Order* that requires price cap carriers to choose between the CALLS plan and setting interstate access rates at forward-looking cost levels.[60] Iowa Telecom's experience demonstrates that, like the CALLS plan, price cap regulation was not

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55 AT&T Comments at B-2.

56 AT&T Comments at B-1.

57 GCI Comments at 8.

58 GVNW Comments at 4-5.

59 The Joint Commenters' interstate revenues, for example, are a mere fraction of the revenues generated by the BOCs. Attachment 2.

60 Emergency Petition for Forbearance of Iowa Telecommunications Services, Inc. (filed Nov. 26, 2001) (seeking forbearance from rule under *CALLS Order* requiring price cap carriers to elect within 60 days of the release of the order to choose the CALLS plan or to set interstate access rates at forward-looking cost levels).

adopted with rural carriers' particular cost and operating characteristics in mind. Price cap regulation, therefore, should not be uniformly imposed on rate-of-return carriers, particularly in light of questionable benefits achieved by the few rural carriers that operate under price cap regulation.

C. There is No Evidence to Indicate that Any Access Charge Reductions Would Be Passed Through to Consumers.

Similarly, the notion that an up-front rate reduction should be a condition of entry for incentive regulation, as advocated by Sprint and GCI,[61] is self-serving and unsupported. While the Joint Commenters fully support an incentive regulation mechanism that shares the benefits of such regulation with consumers, shareholders, IXCs, CLECs and ISPs,[62] the Commission should not be fooled into thinking that reductions in IXC-paid access charges benefit end-users. The Joint Commenters maintain that reductions in access charges will not impact long distance rates.[63] First, there is no evidence that the IXCs will pass on to consumers any savings as the result of access charge reductions. AT&T, in particular, has made clear on at least two occasions that it does not practice what it preaches in its comments. Neither following adoption of the *CALLS Order* nor following adoption of the *MAG Order* did AT&T pass through the mandated rate reductions to consumers.[64] Although AT&T committed in the *CALLS Order* to flow through reductions in switched access usage charges to residential and business long-distance consumers,[65] there is no evidence that AT&T has passed on the reduction to its customers in the form of lower long-distance rates. To the contrary, immediately following issuance of the *CALLS Order*, AT&T announced that it would be raising rates by as much as

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61 Sprint Comments at 3; GCI Comments at 7-8.

62 Joint Comments at 49-54.

63 Joint Comments at 50-51.

64 Rebecca Blumenstein and John R. Wilke, "AT&T to Lift Rates of Long Distance by as Much as 80%," Wall Street Journal, A12, June 7, 2000; Letter to Chairman Powell from Consumer Federation of America, dated July 17, 2001;"AT&T Increases Universal Service Fee", Communications Daily, Jan. 3, 2002 (noting that AT&T, Sprint and Worldcom intend to raise their rates).

65 *CALLS Order,* 15 FCC Rcd at ¶152.

80% for tens of millions of its customers with basic rate plans.[66] Again, on January 1, 2002, rate-of-return carriers lowered their carrier-paid interstate access charges as required by the *MAG Order*; but AT&T did not correspondingly lower its end-user rates in any study area. In fact, despite the mandated access charge reductions, AT&T, Sprint and Worldcom each announced in January of this year that they would be *raising* rates for their basic calling plans for residential customers.[67] AT&T does not serve many rural areas at the same rates as urban areas in direct contravention to Section 254's requirement of reasonable comparability between urban and rural areas.[68] Because rural areas are comprised mostly of residential customers and include a significantly smaller percentage of business customers than urban areas, and because many of the discounted per-minute packages are not available, residential rate hikes in basic calling plans disproportionately affect customers in rural or high-cost areas.[69]

In the face of overwhelming evidence that price cap regulation is inappropriate for many rate-of-return carriers, AT&T, WorldCom, Sprint and Nebraska Rural Independent Companies[70] nevertheless, blithely support mandatory incentive regulation for rate-of-return carriers with careless disregard for the potential consequences such a policy could have for rural Americans who would risk deteriorating service quality and decreased access to new, advanced

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66 Then-Chairman William E. Kennard stated that "AT&T promised to pass on savings to all consumers. Their new rate plan does not do that. It is in our order, and I am going to enforce it." Kennard added that AT&T promised to tell subscribers which plan would be most cost effective for them. "This was not done. I will also hold AT&T to this commitment." Dick Kelsey, "Feds Rip AT&T for Raising Long-distance Rates," Newsbytes (June 7, 2000). *See also* Rebecca Blumenstein and John R. Wilke, "AT&T to Lift Rates of Long Distance by as Much as 80%," Wall Street Journal, A12, June 7, 2000; Letter to Chairman Powell from Consumer Federation of America, dated July 17, 2001.

67 "AT&T Increases Universal Service Fee", Communications Daily, Jan. 3, 2002 (noting that AT&T, Sprint and Worldcom intend to raise their rates).

68 47 U.S.C. §254(b)(3).

69 "The Rural Difference," Rural Task Force, White Paper 2 (Jan. 2000) at 36-37.

70 Sprint Comments at 4; AT&T Comments at 14; WorldCom Comments at 2; Nebraska Rural Independent Companies at 3.

and high-speed services.[71] These commenters ignore overwhelming evidence that the current system does not contain sufficient incentives to invest in high-cost exchanges. As discussed above, these commenters' interest in mandatory price cap regulation has little in common with the Commission's universal service and public interest goals.

V. THE CONDITIONS PRECEDENT FOR PRICING FLEXIBILITY SHOULD BE REASONABLE, NOT UNATTAINABLE.

As the Commission acknowledged when it granted pricing flexibility to the price cap carriers, pricing flexibility confers important benefits on consumers and competition.[72] It encourages efficient, competitive entry by eliminating implicit subsidies and by sending cost-based signals to new entrants.[73] In addition, it benefits consumers by allowing the ILEC to respond to the market with innovative, market-based pricing packages and volume and term discounts.[74] Thus, despite AT&T's assertion that applying pricing flexibility to rate-of-return carriers is premature and simply too administratively burdensome,[75] significant benefits stem from pricing flexibility, and consumers living in high-cost areas should not be denied them. Instead, the Commission should immediately grant rate-of-return carriers pricing flexibility, and define a clear and reasonable roadmap to further deregulation.

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71 "Advanced services" describes facilities and services with an upstream (customer-to-provider) and downstream (provider-to-customer) transmission speed of more than 200 kbps. "High-speed" describes services with over 200 kbps capability in at least one direction. *In the Matter of Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, Third Report, FCC 02-33, (rel. Feb. 6, 2002) ¶8.

72 *MAG Further Notice* at ¶ 249; *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14263, ¶79.

73 Sprint Comments at 6.

74 TCA Comments at 4.

75 AT&T Comments at 22.

Contrary to AT&T's assertion,[76] competition in rate-of-return markets already exists and is growing. Indeed, there are many study areas in which the Joint Commenters are facing significant and increasing competition today.[77] For example, in one rural study area there are three unaffiliated facilities-based competitors. Each competitor is purchasing unbundled network elements and provides retail telecommunications and/or Internet services. In another similar-sized study area, the ILEC has lost more than 10% of its access lines and revenues. In yet another market, the ILEC has lost 75% of its customers to a facilities-based competitor. Rural markets typically have five to seven wireless carriers that are actively competing with the ILEC. Municipal entry into telecommunications also is a growing reality. In addition, cable is among the most aggressive broadband competitors in some of these markets and is expanding into voice communications as well. Given the growing level of competitive entry in rate-of-return markets, the Commission should grant pricing flexibility immediately.

The Commission therefore should adopt reasonable criteria for determining when a carrier can qualify for pricing flexibility and criteria that actually motivates ILECs to open further their local exchange markets. Criteria over which the ILEC has no control, such as presence of competitors with ETC status and universal service support, as proposed by AT&T and CUSC, are inappropriate triggers upon which to grant pricing flexibility. First, these thresholds do not encourage or reward the ILEC for taking steps toward opening its markets, such as rebalancing rates and support, or establishing interconnection or collocation tariffs. In addition, the thresholds do not reflect real-world and inter-modal significant competition from entities such as CMRS carriers and cable broadband operators. Increases in wireless and Internet

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[76] AT&T Comments at 19-20.

[77] Joint Comments at 14-19.

usage over the last several years have eroded local and interstate access revenues while placing demands on the universal service support system. In addition, CMRS carriers and cable broadband operators often are not subject to state regulation, which allows them greater pricing flexibility than rate-of-return carriers. As the Commission considers the appropriate criteria for qualifying for pricing flexibility, it should keep in mind that the competitive environment has changed dramatically since the 1990s when it adopted price cap regulation for the largest carriers. As such, any incentive plan adopted by the Commission should acknowledge declining reliance on the wireline network and the competitive presence of facilities-based LECs, CMRS carriers, and cable operators.

Instead of being overly restrictive, as AT&T encourages, the Commission should adopt a variety of reasonable thresholds for rate-of-return carriers to earn pricing flexibility. Specifically, the Joint Commenters recommend that rate-of-return carriers be allowed to demonstrate any one of the following as indicators that it faces competition within its study area:

- Collocation tariff and interconnection agreement on file with state
- Interconnection tariff or SGAT on file with state
- Presence of a competitor with ETC status in the market
- Loss of 10% of revenues or lines in the market to a competitor, or
- Termination or renunciation of the rural exemption under 251(f)(1)

The Commission has already acknowledged that the thresholds adopted for the price cap carriers may create too high a hurdle for smaller carriers. Thus, it would be irrational for the Commission to impose “more robust” thresholds, as AT&T advocates, particularly in light of the shifts in customer demand for communications services in recent years, as explained above.

VI. RATE-OF-RETURN CARRIERS FACE MARKET PRESSURES AND REQUIRE IMMEDIATE COMMISSION ACTION.

Notwithstanding AT&T's assertion,[78] rate-of-return regulation is not a revenue "guarantee" -- no more so than the low-end formula adjustment under price cap regulation. In fact, if a rate-of-return carrier experiences a shortfall in revenues, it is not guaranteed to recover its expenses, particularly expenses associated with highly competitive services such as DSL. Additionally, like other companies, rate-of-return carriers' access to capital and corresponding cost of capital, and other resources, have been constrained by the overall economic downturn combined with shifts in customer demand for competitors' services. Unlike most price cap carriers, the rate-of-return carriers face another disadvantage in raising capital, which is the fact that they are dwarfed in size by most IXCs, cable companies, and the BOCs. Furthermore, demands from regulators and the increasingly competitive telecommunications market impose real and growing pressure on rate-of-return carriers to deploy new and more advanced services without increasing rates.

As TCA aptly notes,[79] the competition faced by rural LECs is not the kind that could be forestalled by the ILEC; it is typically intermodal, from a cable, wireless or satellite company with its own facilities or from another facilities-based LEC with a presence nearby. Nor can the ILEC delay competition by refusing to allow a competitor to collocate because, as often is the case with competing CMRS carriers and cable operators, the competitor does not have a need to collocate in the ILEC's central office. Competition from CMRS carriers and cable operators often goes unregulated by the state public utility commissions, thereby allowing

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[78] AT&T Comments at 21-22.

[79] TCA Comments at 4-5.

them even greater flexibility to offer pricing packages such as expanded calling areas that the ILEC cannot match, eroding both the ILEC's toll and access revenues. Revenue losses due to declining growth in lines and access minutes and competition for capital necessitate that rate-of-return carriers identify new and growing markets. Instead of hindering growth, Commission regulations should provide carriers with the appropriate incentives to venture into new markets.

Adopting an incentive-based alternative rate regulation plan will promote efficient competition and the deployment of advanced services in rural America, while requiring minimal enforcement and monitoring from federal regulators. The Commission should see to it that consumers receive the benefits of incentive regulation as soon as possible. Accordingly, the Joint Commenters urge the Commission to take prompt action in this docket such that the new regulations can be implemented by July 1, 2002 (elimination of the all-or-nothing rule) or January 1, 2003, at the latest (election of alternative regulation and qualification for pricing flexibility).

VII. CONCLUSION

For the foregoing reasons, the Joint Commenters urge the Commission to (1) eliminate the all-or-nothing rule; (2) adopt an incentive regulation plan that rate-of-return carriers can elect on a study area basis and that includes reasonable conditions precedent; and (3) take prompt action to adopt such an incentive-based alternative system.

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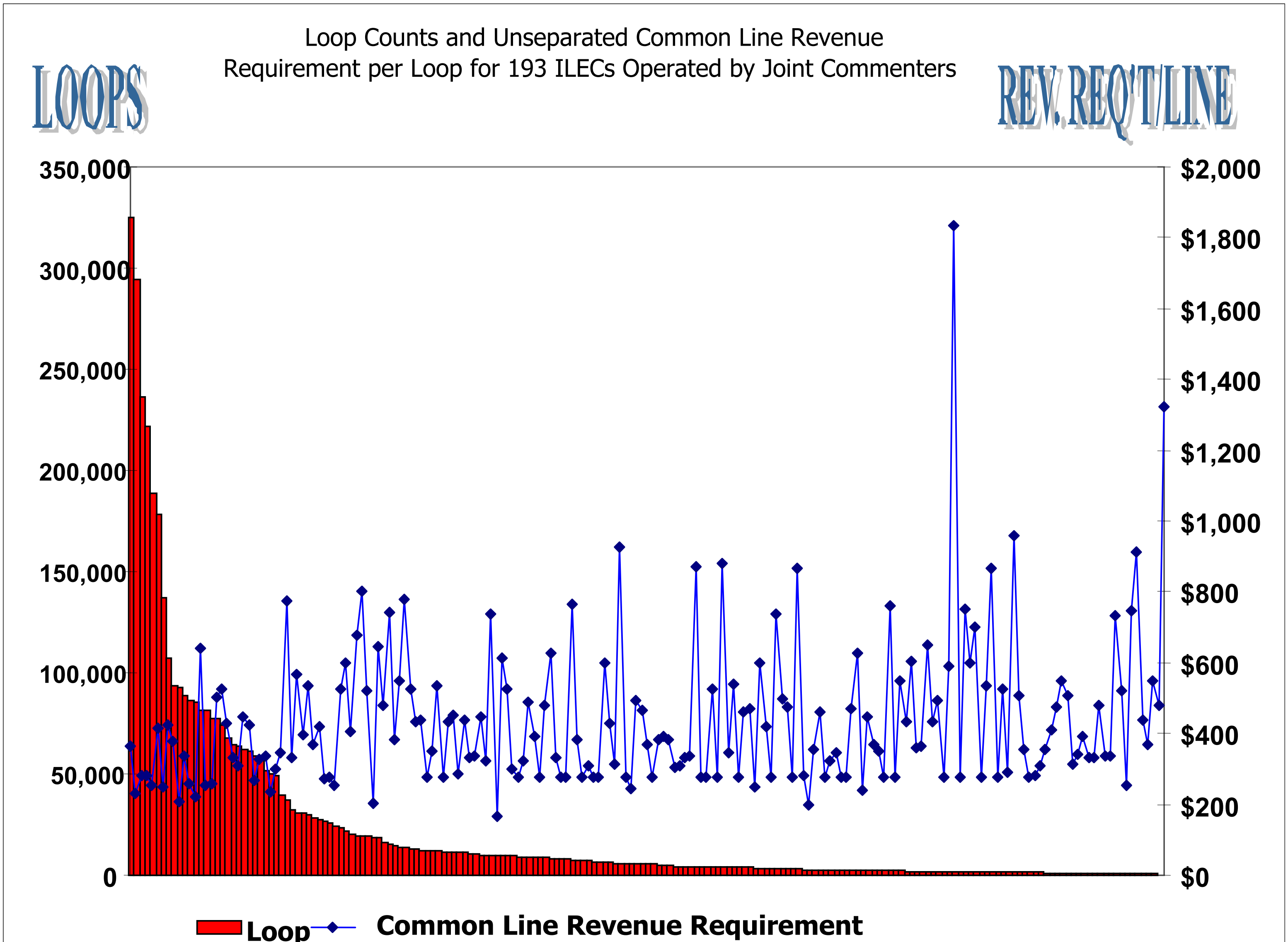

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Attachment

Interstate Regulated Revenues (CY2000)
in $ Billions